Flexible Rate Filing Insurance Rate Regulation as Alternative to Incentive Incompatibility in Prior-Approval

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Abstract

Competition can be an effective regulator of rates in property-casualty insurance markets. While many states have moved to file-and-use or use-and-file provisions, some have adopted flexible rate-filing regulations (flex-rating) as a means of combining competitive forces with prior-approval regulation. This short note proposes a change to flex-rating so that it can be used to gradually transition a state from prior-approval to file-and-use or use-and-file.

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Introduction

The National Association of Insurance Commissioners (NAIC) holds the position that competition can be an effective regulator of rates in property-casualty insurance markets (Eley 2000, p. 281). Also, much of the academic literature on the topic of rate regulation asserts that competition delivers greater benefits than does binding rate regulation. For example, see (Cummins 2002).

Nevertheless, some regulators may be hesitant to suddenly shift to competitive rating. Although some regulators have moved to flexible rate-filing regulation (flex-rating), most of the states with flex-rating have thresholds that are legislatively fixed and as such, do not provide the option of a transition to competitive rating—this note proposes that flex-rating be a vehicle for regulatory transition.

Flexible Rate-Filing Regulation

Flex-rating generally allows an insurer to increase or decrease rates within a "flex band" without prior approval while still requiring prior approval for rate changes outside of the flex band (Insurance Information Institute 2008).

The combination of the two systems (use-and-file or file-and-use co-joined with prior approval) into the flex-rating system allows insurers to make small rate adjustments on a yearly basis to accommodate changing costs, frequencies, or severities.

Flex-rating is and can be used in a number of different property-casualty lines including homeowner's, commercial, and personal auto. For personal auto, it is currently used in Alaska, North Dakota, Kentucky, South Carolina, New Jersey, Rhode Island, and Connecticut (Property Casualty Insurers Association of America 2007). Table 1 summarizes the characteristics of flex-rating systems in these states.

Table 1, Summary of States With Personal Automobile Insurance Flex-Rating Systems

	Thresholds		Wait Times for Filings		Actuarial Support For Simplified Filings?	# of Allowed Simplified Filings Per Year/ 12 Months
	Rate Level	Other*	Simplified †	Prior Approval		
Alaska	10%	n/a	n/a	30 days	no	multiple
North Dakota	5%	n/a	n/a	60 days	yes	1
Kentucky	n/a	25%	n/a	30 days	yes	multiple
South Carolina	7%	25%	30 days	60 days	yes	1
New Jersey**	3%	10%, 15%	30 days	45 days	yes	1 increase, multiple decreases
Rhode Island	5%	n/a	n/a	30 days	yes	multiple
Connecticut	6%	n/a	n/a	30 days	no	multiple

While there are more details to flex-rating in different lines, this table summarizes the main features and variance in rules among states that use it for automobile insurance.
†Simplified filings are those that are either file-and-use or use-and-file.
* "Other" refers to either a threshold that applies to risk classifications or one that applies to coverage rates and factors (depending on the state).
** New Jersey's system allows for *limited* filings as opposed to *flex-rate* filings.

Table 1 summarizes the typical characteristics of flex-rating: thresholds on the rate level, risk classification, or coverage rates and factors; a shorter wait-time relative to the prior approval process; sometimes the absence of actuarial support for simplified filings; the number of allowed filings per year or twelve months under the simplified filing process. These factors can combine to make the simplified file-and-use or use-and-file process more attractive to insurers than the prior-approval process and may reduce actuarial and/or administrative costs to prepare and review filings.

A Minute Problem with Typical Flex-Rating Systems

The problem with flex-rating systems is that they are typically based on controlling changes relative to last year's rates. If an insurer in North Dakota has a rate level that is indexed at 100 in 2008, the maximum rate level he can achieve in 2009 will be 105 and in 2010 will be 110.25 and in 2011 will be 115.76… and so on. However, if the insurer in North Dakota takes even one rate level decrease, he will never be able to attain the same rate levels in the future (under/using the simplified filing process) that he would otherwise have been capable of achieving. Although he will be able to regain the rate level using a prior-approval filing, a one-time rate reduction under flex-rating permanently lowers the achievable rate level (through simplified filings) for all other years. Therefore, there is a small incentive compatibility problem with current flex-rating systems that may work against the intended aim of the regulator(s). Expectations of future increases may prevent insurers from lowering premium rates in the short term for fear of not being able to raise rates when needed.

The typical flex-rating system sets a threshold for the rate level but does not set it for any individual coverage or risk classification. This means that an insurer can change the rates by any amount for any risk classifications so long as the overall rate level remains unchanged. Some states also (or only) place restrictions on individual risk classifications. Interestingly, a threshold that applies to risk classifications and not to the rate level effectively limits rate level changes as well. Kentucky, for example, has a threshold of 25% that applies to risk classifications but not to the overall rate level, meaning that no risk classification should receive rate increases under the simplified filing process that are greater than 25% per year; since insurers cannot raise any individual risk classification by more than 25%, they cannot raise their overall rate level by more than 25% either. This means that the incentive compatibility problem applies to both types of thresholds: rate level as well as risk classifications/ coverages.

Consider the hypothetical case of an insurer in North Dakota, with a rate level that we arbitrarily index to 100, as above. If an insurer takes a simplified rate level decrease of 5% so that his 2009 rate level is 95, the most it can ever be in 2010 is 99.75 and the most it can ever be in 2011 is 104.74; in both 2010 and 2011, the figures are strictly lower than they could have been if he had not taken that one-time rate decrease. This will be true for all years after the rate cut.

As the time horizon lengthens, the difference between what can be and what could-have-been widens. These differences are actually an opportunity cost to the insurer—an opportunity that is foregone when he takes a one-time rate decrease. If these opportunity costs are discounted back to the time at which the insurer decides to take a rate decrease or not, the net-present-value could potentially be of a large magnitude. Although the rate decrease might only lower yearly revenue by a small magnitude, the actual cost, the opportunity cost, is larger.

And so, the problem with typical flex-rating systems is that the actual cost of a rate decrease (the discounted value of all of the lost opportunity) is actually higher than it appears to be (ignoring the prior approval opportunity for rate increases). When an insurer decides whether to take a rate decrease under flex-rating, he should consider the

opportunity cost[2]. Given a high opportunity cost, rate decrease filings may not be as numerous and/or substantial as they otherwise might be.

A Possible Solution

A possible solution to the problem was hinted at in the state of New York when flex-rating for personal automobile insurance was experimented with (discontinued August 2, 2001). New York's regulation dictated that insurers could reduce their rates but that they could always come back to the highest rate level they had previously been approved for (see Regulation No. 153 (11 NYCRR 163) Section 163.2 (e)).

Prima facie, this may appear to be against the consumer's interest, but given the ability of competitive forces to regulate rates, it would likely be the opposite. An insurer that knows it can always come back to its previously approved rate level (or higher) should be more willing to lower rates in any time period than he otherwise would have been willing to do, *ceteris paribus*.

Dynamic Transition from Prior Approval to Competitive Forces

Regulators who suppress rates generally recognize that in order for the participation constraint to be met, rates must increase with costs. If a rate level of 100 is approved in 2008 and costs increase by 5%, a rate level of 105 in 2009 should be permissible, and so on.

Regulators intent on moving towards competitive forces can use an altered flex-rating system to achieve a gradual transition. The altered flex-rating system would include an indexing of rate levels but the index would increase each year regardless of whether the insurer filed for higher rates or not. If the rate level was 100 in 2008 and the threshold was 5%, the rate level index would increase to 105 in 2009 and 110.25 in 2010 and 115.76 in 2011 and so on. Regardless of what the insurer's rates were in 2010, he could always use rates up to and including the rate level of 115.76 in 2011. In order to phase-out the prior-approval portion of flex-rating, the threshold would only need to be larger than the cost increase.

For this to work, the cost increase would have to be that which is particular to the automobile insurance product. In the absence of a good measure of automobile insurance product inflation, proxies might be considered/ created from general economic price level information.

So long as the flex-rating threshold was larger than the increase in automobile insurance costs, the relative size of the flex-rating threshold would increase each year so that the flex-rating threshold would eventually be non-binding on all insurers' rate setting processes. The threshold could be cost increases plus some loading of, say, one, two, three percent or more. Depending on the size of the loading, the state would reach a *de facto* competitive system earlier or later.

If the size of the flex-rating threshold (which is really a "band" within which insurers can change prices without prior-approval) grows/ increases in relative size each year, the "band" will eventually become a moot issue since it will not bind upon any insurers.

[2] Although all flex-rating states would still allow the insurer to make a filing for a higher rate level increase using the prior approval process, on the aggregate, it is likely that there would be fewer rate filing decreases than there otherwise could be—the NPV opportunity cost makes it much more costly to file for a rate decrease than it otherwise would be.

Conclusion

This brief note has outlined flex-rating for insurance rate regulation as a mechanism for gradual transition from prior-approval to competitive rating in property-casualty insurance markets. It has also identified that the opportunity cost of a simplified rate decrease under flex-rating may be much larger than it appears to be.

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